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UNCLAS SECTION 01 OF 03 SAO PAULO 000476

STATE PASS USTR FOR KDUCKWORTH
STATE PASS EXIMBANK
STATE PASS OPIC FOR DMORONSE, NRIVERA, CMERVENNE
DEPT OF TREASURY FOR JHOEK, BONEILL

SIPDIS
SENSITIVE

E.O. 12958: N/A
TAGS: ECON EFIN EINV ETRD BR
SUBJECT: BRAZIL'S CURRENT ACCOUNT DEFICIT NOT WORRISOME

SENSITIVE BUT UNCLASSIFIED--PLEASE PROTECT ACCORDINGLY

REF: Sao Paulo 0268

¶1. (SBU) Summary: Brazil is set to run its first current account deficit since 2002; however, unlike previous years, the more stable composition of the balance of payments should protect the Brazilian economy from crises. The floating exchange rate, smaller share of foreign currency denominated debt, status as an investment grade sovereign, and record-shattering foreign direct investment inflows all put Brazil in a better position to manage its current account deficit. The primary drivers behind the deficit are twofold. Brazil's external financing profile has moved from debt to equity, and profit and dividend remittances have replaced interest payment outflows. The declining trade surplus due to the growth in capital-intensive imports is also contributing to the current account deficit, as companies boost investment spending. Although the Brazilian currency has appreciated by 25 percent against the U.S. Dollar over the last three years, many interlocutors disagree on its impact on Brazil's trade balance. Despite the GOB's efforts to boost exports, the decline in the trade surplus is likely to continue. Different from the historical crises associated with current account deficits, Brazil's current account deficit is now more of a signal that foreign investors recognize Brazil's potential. End Summary.

Historically Bad, But Not This Time

¶2. (SBU) Brazil will close out 2008 with a current account deficit of approximately 1.9 percent of GDP; the first deficit in five years. Current account deficits in Brazil were common and have historically been an ingredient for disaster. Since 1947 when the Brazilian Central Bank first began measuring the current account, Brazil has registered a surplus only 12 times, with five of those occurrences in the last five years.

¶3. (SBU) According to Itau Bank, the composition of the current account is very different than in the 1990s when Brazil ran current account deficits of more than four percent of GDP. Brazil no longer has a pegged exchange rate; the floating rate will help to automatically correct any current account imbalance before it becomes unsustainable. Brazil also has a large stockpile of foreign reserves and is a net external creditor, which means that Brazil's external accounts now actually benefit when the Brazilian currency

depreciates.

¶4. (SBU) Brazil's capital/financial account inflows are very different today than in the past. Foreign direct investment (USD 34 billion in 2007) and portfolio inflows have substituted debt as an important financing source, resulting in increased outflows of profit and dividend remittances, negatively impacting the current account. According to Unibanco economist Darwin Dibb, soaring outflows of profits and dividends have already inflicted more damage to the current account than the shrinking trade balance. Through 2003, profit and dividend remittances were approximately USD five billion. Since then, the two have grown exponentially to close to USD 30 billion. Both signal the more stable move in Brazil's external financing from debt to equity. Both are sustainable in the event of an economic downturn because dividends and profits retract while interest payments are fixed.

¶5. (SBU) The new financing profile also represents a change in perception about Brazil. Increased foreign direct investment and portfolio inflows suggest that the world seems willing to finance Brazil's transition towards a credible economy with solid macroeconomic stability. The fact that Brazil is now investment grade reduces the likelihood of sudden outflows. According to Merrill Lynch, a current account deficit of up to three percent of GDP is consistent with a country that receives foreign savings to fund investment, given the higher domestic return on capital.

¶6. (SBU) Brazil had habitually financed its domestic spending via foreign denominated debt, which implied outflows of interest payments to foreign creditors; however, in the last few years Brazil has reduced its net external debt as share of GDP. Itau Bank

reported that interest payment outflows as of May were one fourth the size of those paid only three years ago.

¶7. (SBU) The consistent decline of Brazil's trade balance since May 2007 is another reason for the resurgence of Brazil's current account deficit. Through August, Brazil's trade surplus was down 38 percent from last year to USD 16.9 billion. (Note: The trade surplus peaked at USD 47.8 billion in May 2007. End Note.) The sharp rise in imports is the chief culprit for the declining trade surplus. While the value of exports was up 29 percent through August, imports were up a whopping 54 percent. The Center of External Trade Studies Foundation (Funcex) reported that export volumes grew by only 1.2 percent over the last year, reflecting the deceleration of external demand. Booming domestic demand in Brazil, however, pushed import volumes up 23 percent during the same period. Brazil's recent imports have been highly capital-intensive, primarily due to the sharp rise in investment spending now occurring in Brazil. Despite the 25 percent appreciation of the Brazilian currency in the last three years (it peaked at nearly 35 percent in July), interlocutors have disagreed about how much of an impact the exchange rate has had on the trade balance.

Reversing the Spread

¶8. (SBU) Faced with the declining trade balance, the GOB has become increasingly aware of encouraging export growth and has taken several measures to boost exports. Indeed, the Brazilian Sugarcane Industry Association's (UNICA) chief U.S. representative Joel Velasco told Econoff that the GOB is starting to catch up to global changes. Velasco said that Brazil's pro-agreement behavior during the latest round of Doha talks demonstrated the shift from the inwardly focused approach of exporting only domestic surplus to the recognition that exports play an important role. In May, the Ministry of Development, Industry, and Foreign Trade announced a new industrial policy designed to spur small and medium sized companies to export (reftel). The GOB also increased the export target for this year to USD 190 billion in July, compared to USD 160 billion in exports in 2007.

Expect More of the Same

¶9. (SBU) Economic interlocutors are expecting the trade balance and profit and dividend remittances to continue to put downward pressure on the current account. Unibanco forecasted the trade surplus for 2008 to be approximately USD 23 billion, down 43 percent from 2007. Economist Mauricio Oreng from Itau Bank believes that Brazil would continue to run a current account deficit and that it would approach three percent of GDP by 2012.

¶10. (SBU) Despite the downward pressure on the Brazilian currency because of the recent decline in commodities, the trade surplus is unlikely to reverse the trend over the short-term. Merrill Lynch told Econoff that Brazil has benefited relatively little from the commodity price boom (a modest 1.2 percent of GDP by their calculations) because the Brazilian economy remains relatively closed and with a diverse trade in goods and services. Trade represents approximately 25 percent of Brazil's GDP and Brazilian commodity exports make up only five percent of GDP, according to Merrill Lynch.

Comment

¶11. (SBU) The narrowing trade surplus, and by extension, the widening current account deficit, are a reflection that the Brazilian economy is outperforming other emerging economies. A combination of strong imports, flattening terms of trade, and a softening global demand should prompt a continued decline in Brazil's trade balance over the coming years. Likewise, the recent upgrade to investment grade should power further foreign direct investment and portfolio inflows to finance the current account. The current account deficit is now more flexible and would automatically adjust during an economic downturn as businesses become less profitable, causing dividend payments and purchases of

capital goods imports to diminish. Going forward, Brazil needs to pursue measures to further stabilize the economy and raise productivity, capitalizing on the inflows of foreign savings to foster greater competitiveness. End Comment.

¶12. (U) This cable was cleared by the US Treasury Financial Attache in Sao Paulo and by Embassy Brasilia.

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